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In the Supreme Court of the United States

OCTOBER TERM, 1979

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

RICHARD R. QUINLIVAN AND ANN M. QUINLIVAN, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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CITATIONS

Cases:

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (App. A, *infra*, 1a-8a) is not officially reported. The opinion of the court of appeals (App. B, *infra*, 9a-20a) is reported at 599 F.2d 269.

JURISDICTION

The judgment of the court of appeals was entered on May 24, 1979 (App. C, *infra*, 21a). By order dated August 16, 1979, Mr. Justice Blackmun extended the time for filing a petition for a writ of certiorari to and including October 21, 1979 (a Sunday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondents are entitled to a business expense deduction under Section 162(a)(3) of the Internal Revenue Code of 1954 for purported "rental" payments made under a prearranged gift and leaseback transaction having no business purpose other than to divert income to their children, pursuant to which they contemporaneously transferred an office building to short-term trusts for the benefit of their children and leased the building back from the trustee throughout the term of the trust, while retaining a reversionary interest in the property upon the termination of the trust.

STATUTES AND REGULATION INVOLVED

Section 162(a)(3) and Sections 671 through 678 of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulation on Income Tax (1954 Code), Section 1.671-1(c) (26 C.F.R.) are set forth in Appendix D, *infra*, 22a-35a.

STATEMENT

1. The facts were fully stipulated and may be summarized as follows: Respondents [1] Richard R. Quinlivan and Robert P. Quinlivan are attorneys who practice law in St. Cloud, Minnesota. They began the practice with their father in the 1950s and continued as members of the same firm following his death in 1961 (App. A, *infra*, 2a; App. B, *infra*, 10a). In 1963, respondents began construction of an office building in which each owned an undivided one-half interest. Upon completion of the building, respondents' law firm became the sole occupant of the building (App. A, *infra*, 2a-3a; App. B, *infra*, 10a).[2]

On January 2, 1964, each respondent transferred his one-half interest in the office building to the Northwestern National Bank of Minneapolis as trustee under a separate trust for the benefit of his children. The trusts were established on the same day and were irrevocable for a term of ten years and six months. At the conclusion of the term, the trust property was to revert to respondents (App. A, *infra*, 3a; App. B, *infra*, 10a-11a).

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[1] The term "respondents" refers to Richard and Roger Quinlivan. Ann and Joyce Quinlivan are parties solely because they filed joint federal income tax returns with their husbands during the years in issue (App. A, *infra*, 2a; App. B, *infra*, 10a, note 2).

[2] At this time, respondents were the only members of the law firm. Subsequently, at some time prior to the years in issue, another partner joined the firm (Exs. 7-G, 12-L).

Shortly after the establishment of the trusts, the trustee and respondents' law firm entered into a written lease under which the firm leased back the building that respondents had transferred to the trusts.[3] The initial lease was for three years and contained a renewal option at the expiration of the term "at a rental and terms to be agreed upon" (App. A, *infra*, 3a; App. B, *infra*, 11a). Subsequent agreements increased the rent and continued the law firm's tenancy; each subsequent lease contained the same renewal option provision (App. B, *infra*, 11a). After the termination of the trusts and the reversion of the building to respondents on July 2, 1974, the law firm leased the office space from respondents for an amount that was not less than the highest rent paid to the trustee during the period it held the property (App. A, *infra*, 3a-4a).

2. In computing their net income from the law practice for each of the years at issue, respondents claimed business expense deductions for "rentals" under Section 162(a)(3) of the Internal Revenue Code of 1954 equal to their aliquot partnership share of the payments made by the law firm to the trustee pursuant to the leaseback arrangement. On audit, the Commissioner of Internal Revenue disallowed the rental deductions, increased respondents' share of their law firm's income, and accordingly determined deficiencies (App. A, *infra*, 2a; App. B, *infra*, 12a).

[3] The term of the lease commenced as of January 2, 1964; however, the lease was executed by the parties three weeks later (Ex. 12-L).

In the Commissioner's view, the rentals were not an ordinary and necessary business expense because the obligation to pay such rentals arose out of a transaction serving no business purpose and having the sole objective of tax avoidance (App. B, *infra*, 12a).

In this suit brought by respondents for redetermination of the deficiencies, the Tax Court held that respondents' payments to the trustee were deductible under Section 162(a)(3) as "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." Pursuant to the Tax Court's analysis, respondents' gift and leaseback satisfied the four-part test it announced in *Mathews* v. *Commisioner*, 61 T.C. 12 (1973), rev'd, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976). First, the Tax Court concluded that respondents did not retain substantially the same control over the property that they had before they made the gift because they employed an independent trustee. Second, the leaseback was in writing and required the payment of a reasonable rental. Third, the court ruled that the leaseback (as distinguished from the gift) had a bona fide business purpose because respondents' continued use of the building was essential to the conduct of their law practice. Fourth, the court concluded that respondents' reversionary interest in the property was not a disqualifying "equity" within

the meaning of Section 162(a)(3) (App. A, *infra*, 5a-8a).

3. The court of appeals affirmed on three independent grounds (App. B, *infra*, 9a-20a). It first concluded that respondents' payments met the literal requirements for deductibility as "rentals" under Section 162(a)(3) because: (1) the payments were required to be made for the continued use or possession of the property; (2) respondents' continued use or possession of the property was for purposes of their trade or business; (3) respondents had not taken and were not taking title to the property; and (4) respondents had no equity in the property (App. A, *infra*, 13a-15a). As the court of appeals saw the matter, "[i]t is clear that application of the plain meaning of section 162(a)(3) to the facts of this case justifies the deduction" (*id.* at 15a).

As a second ground for affirmance, the court of appeals approved the four-part test applied by the Tax Court and concluded that it complemented its own analysis based upon the literal meaning of Section 162(a)(3). In so holding, the court rejected the rationale of the decisions of the Fifth and Fourth Circuits upholding the government's position that a business deduction for rent is allowable only if there is a business purpose for the entire transaction, including the transfer of the property from the taxpayer and the leaseback. See, *e.g.*, *Van Zandt* v. *Commissioner*, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965); *Mathews* v. *Commissioner*, 520 F.2d 323 (5th Cir. 1974), cert. denied, 424 U.S. 967

(1976); *Perry* v. *United States*, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976).

While the court of appeals acknowledged that "for tax purposes the overall nature of a transaction must be considered" (App. B, *infra*, 17a), it observed that "in addition to all recent cases of the Tax Court not appealable to the Fifth Circuit, several courts have adopted positions inconsistent with the Commissioner's contentions and consistent with our holding in this case" (App. B, *infra*, 15a). See *Brooke* v. *United States*, 468 F.2d 1155 (9th Cir. 1972); *Brown* v. *Commissioner*, 180 F.2d 926 (3d Cir.), cert. denied, 340 U.S. 814 (1950); *Engel* v. *United States*, 400 F. Supp. 5 (W.D. Pa. 1975), aff'd by an equally divided en banc court, 562 F.2d 41 (3d Cir. 1977). As its second basis for affirmance, the court of appeals concluded that "to the extent that there may be a split in the courts on this issue, we adopt the majority view as applied by the Tax Court below" (footnote omitted) (App. B, *infra*, 17a-18a).

Even if it had not held that Section 162(a)(3) expressly authorized respondents' deductions or adopted "the majority view as applied by the Tax Court * * *" (App. B, *infra*, 17a-18a), the court of appeals would nevertheless have affirmed on the third independent ground that the income from the trusts was taxable to the beneficiaries under the grantor trust rules of Sections 671-678, App. D, *infra*, 22a-35a (App. B, *infra*, 18a-20a). In the court of appeals' view, the rental deduction provision of Section 162(a)(3) and the grantor trust rules of Sections

671-678 must be read *in pari materia*. It accordingly ruled that the taxation of the income of the trusts to the beneficiaries and not to respondents necessarily required the conclusion that respondents were entitled to the rental deduction for the payments to the trust (App. B, *infra*, 20a).

REASONS FOR GRANTING THE PETITION

The decision below holding that respondents are entitled to a business expense deduction for "rentals" paid to a trustee of a short-term trust for the benefit of their children in a gift and leaseback arrangement conflicts with *Van Zandt* v. *Commissioner*, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965); *Mathews* v. *Commissioner*, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976); and *Perry* v. *United States*, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976). In those cases, the Fourth and Fifth Circuits have rejected similar attempts by taxpayers to split their income with their children by creating rental deductions for the use of business property by means of gift and leaseback arrangements with short-term trusts. This Court should resolve the conflict and establish a national rule with respect to this type of transaction.

1. The typical gift and leaseback device contains the following elements: The grantor-taxpayer owns a building which he occupies in the conduct of his trade or business. He transfers the building to a trust with a term slightly in excess of ten years for the benefit of his children, with a reversion to him

upon termination of the trust. Simultaneously with the transfer, the grantor leases the building back from the trust, for a total period that is usually coextensive with the term of the trust. The grantor thereafter claims business expense deductions for the "rentals" paid to the trust, thereby reducing his high-bracket taxable income, and shifting the taxation of the "rentals" to his children, who are typically low-bracket taxpayers. If the arrangement is given effect for tax purposes, the gift and leaseback device enables high-bracket taxpayers owning realty that they put to business use to reduce their taxable income by what are in fact non-deductible payments to the natural objects of their bounty.

Contrary to the decision below, the Fifth and Fourth Circuits have refused to permit business expense deductions for purported rentals in similar arrangements. Those courts have upheld the Commissioner's position that "rentals" paid pursuant to a gift and leaseback transaction are not deductible business expenses unless the taxpayer shows a business purpose for the transaction as a whole. Thus, in *Van Zandt* v. *Commissioner*, *supra*, which involved a similar trust device for diverting income to the taxpayer's children, the Fifth Circuit emphatically rejected the notion, adopted by the court below, that it is sufficient if there is a business purpose for the leaseback. In holding that the taxpayer's payments to the trust were not deductible, *Van Zandt* concluded that (341 F.2d at 443) "inevitably we must look at

the original conveyance of the property together with the execution of the lease-back as a single transaction. Thus reviewing it, we conclude that the *obligation* to pay rent resulted not as an ordinary and necessary incident in the conduct of the business but was in fact created solely for the purpose of permitting a division of the taxpayer's income tax" (emphasis in original).

Although the taxpayer in *Van Zandt* named himself trustee, the Fifth Circuit subsequently held in *Mathews* v. *Commissioner, supra,* 520 F.2d at 323, that "[t]he outcome would not have differed had there been an outside independent trustee" (*id.* at 325). In ruling in favor of the government in a case involving an independent trustee, the court in *Mathews* emphasized that the "[t]axpayers' effective control of the property for the duration of the term was practically assured, notwithstanding the trustee's independence * * *. In short, before the trust's creation Taxpayer operated his business on and with necessary property—all under his complete control. The same was true afterward—except he hoped some of his income had been siphoned off to his children. As in *Van Zandt* what was carefully planned to achieve a total result cannot be split into separate parts" (*ibid.*). Accord: *Perry* v. *United States, supra,* 520 F.2d at 239.

Thus, as matters now stand, respondents' transaction, employing an independent trustee, would pass muster in the Eighth Circuit but not in the Fourth or Fifth Circuits. There is accordingly a square con-

flict between the decision below and *Mathews* and *Perry.*[4]

Finally, the question presented is important to the proper administration of the revenue laws. It has produced substantial litigation in recent years and it is expected that the number of cases will increase unless the conflict among the circuits is resolved. The deductibility of rental payments arising out of gift and leaseback arrangements has been involved in at least 19 decided cases.[5] Moreover, we are advised by

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[4] Although the court of appeals stated that "to the extent that there may be a split in the courts on this issue, we adopt the majority view as applied by the Tax Court below" (App. B, *infra,* 17a-18a), it also expressed doubt as to whether "there exists a true split among the courts of appeals" (App. B, *infra,* 17, note 4). The court there recognized that the Fifth Circuit's *Mathews* decision conflicts with its own and is unpersuasive in suggesting that the pre-*Mathews* Fifth Circuit decision in *Audano* v. *United States,* 428 F.2d 251, which also held for the government, somehow suggests that "the real conflict may be among cases in the Fifth Circuit." Moreover, the court's attempted reconciliation of *Perry* with what it characterized as the "majority view" on the basis of the "tightly drawn leases" in *Perry* ignores the Fourth Circuit's own analysis in that case. In *Perry,* the court observed that "[w]e think our cases are indistinguishable from *Van Zandt,* that the latter was correctly decided, and that it should be applied here" (520 F.2d at 237). The court there further rejected the bifurcation of the overall transaction (*id.* at 238-239) upon which the decision below relies (App. B, *infra,* 14a, 16a). See pages 12-14, *infra.* There is thus a clear conflict between *Van Zandt, Perry* and *Mathews,* on the one hand, and the decision below.

[5] *Skemp* v. *Commissioner,* 168 F.2d 598 (7th Cir. 1948); *Brown* v. *Commissioner, supra; Brooke* v. *United States, supra; Van Zandt* v. *Commissioner, supra; Perry* v. *United States, supra; Mathews* v. *Commissioner, supra; Engel* v. *United States, supra; Finley* v. *Commissioner,* 255 F.2d 128

the Internal Revenue Service that there are currently 15 docketed cases pending in the Tax Court and 45 additional cases pending at various administrative levels in the Service presenting the issue.

2. The fundamental error by the court below, as well as by the decisions in *Brooke* v. *United States*, 468 F.2d 1155 (9th Cir. 1972); *Brown* v. *Commissioner*, 180 F.2d 926 (3d Cir.), cert. denied, 340 U.S. 814 (1950); *Engel* v. *United States*, 400 F. Supp. 5 (W.D. Pa. 1975), affd. by an equally divided en banc court, 562 F.2d 41 (3d Cir. 1977); and *Skemp* v. *Commissioner*, 168 F.2d 598, upon which it relied (App. B, *infra*, 15a-16a), was to bifurcate these integrated gift and leaseback devices into two unrelated transactions of gift and leaseback having separate and independent status. After breaking down the transaction into separate components, the court below concluded the grantor's rental payments served a business purpose because they were required to be made to permit the continued use of the building for his business.

(10th Cir. 1958), aff'd, 265 F.2d 885, cert. denied, 361 U.S. 834 (1959); *Audano* v. *United States, supra; Wiles* v. *Commissioner*, 491 F.2d 1406 (5th Cir. 1974); *Chace* v. *United States*, 422 F.2d 292 (5th Cir. 1970); *Furman* v. *Commissioner*, 381 F.2d 22 (5th Cir. 1967); *Felix* v. *Commissioner*, 21 T.C. 794 (1954); *Oakes* v. *Commissioner*, 44 T.C. 524 (1965); *Penn* v. *Commissioner*, 51 T.C. 144 (1968); *Butler* v. *Commissioner*, 65 T.C. 327 (1975); *Zumstein* v. *Commissioner*, T.C.M. (P-H) ¶ 73,045 (1973); *Serbousek* v. *Commissioner*, T.C.M. (P-H) ¶ 77,105 (1977); *Lerner* v. *Commissioner*, 71 T.C. 290 (1978), appeal pending, No. 79-4129 (2d Cir.). Cf. *White* v. *Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952).

But splitting the transaction into separate components blinks at the reality inherent in these cases that the gift and leaseback are integral parts of a prearranged plan. Unlike the situation where two independent parties enter into a lease arrangement pursuant to which rent is paid in exchange for the occupation of realty, here the taxpayers have themselves temporarily created the obligation to pay rent on property that they themselves owned outright and will continue to own outright after the termination of the trust. As the Fifth Circuit succinctly put it in *Mathews* v. *Commissioner, supra*, 520 F.2d at 325, "[i]f we stood at the top of the world and looked down on this transaction—ignoring the flyspeck of legal title under state law—we would see the same state of affairs the day after the trust was created that we saw the day before."

Since respondents' short-term trusts and the lease were essential elements of a prearranged plan,[6] there is no basis for the bifurcation of the overall transaction by the decision below. Indeed, this Court long

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[6] Although the Tax Court stated in its opinion that "the leaseback" was not prearranged (App. A, *infra*, 7a), it made no finding to this effect and the fully stipulated facts do not support such an inference. To the contrary, the close proximity in time between the gift and leaseback, coupled with the fact the building housed respondents' law practice, supports the conclusion that respondents intended to lease back the property at the time they conveyed it to the trusts. Indeed, in affirming the Tax Court, the court of appeals did not adopt its conclusion that there was no prearrangement but relied upon *Brown* and *Skemp* in which the fact of prearrangement was undisputed.

ago established the fundamental principle that transactions designed and executed as integral parts of a single plan will not be given independent tax significance but will be regarded together in determining the tax consequences of the overall transaction. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935); *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613-614 (1938); *Griffiths* v. *Commissioner*, 308 U.S. 355, 357-358 (1939). See also *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1939); *Knetsch* v. *United States*, 364 U.S. 361 (1960). "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Gregory* v. *Helvering*, *supra*, 293 U.S. at 470.

3. The decision below also erred in concluding, as its third ground of decision, that the fact that the income of the trusts was taxable to the beneficiaries and not to respondents under the grantor trust rules of Sections 671-678 justified respondents' rental deduction under Section 162(a)(3) (App. B, *infra*, 18a-20a). There is, however, no necessary correlation between the taxation of the income from the trusts and the deductibility of the payments to the trusts. Indeed, in enacting the grantor trust provisions, Congress specified that they were to have "no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement." S. Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954). See *Perry* v. *United States*, *supra*, 520 F.2d at 237, n. 2. In ruling that the grantor trust rules and Section 162(a)(3) are to be

construed *in pari materia* (App. B, *infra*, 20a), the court of appeals disregarded the clearly expressed intent of Congress.[7]

In sum, viewing the creation of the trust and the leaseback as a single integrated transaction, it is plain that respondents' "obligation to pay rent" was not an ordinary and necessary incident to a transaction with a real business purpose. Hence, they were not entitled to a business expense deduction for such payments.

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[7] The decision below found the statement in the Senate Report not authoritative because it was not also set forth in the House Report (see App. B, *infra*, 19a). But the Senate considers revenue measures after the House and the two bodies thereafter confer on such legislation. There is accordingly no justification for the court of apeals' conclusion that the views expressed in the Senate Finance Committee Report do not represent the intent of Congress.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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OCTOBER 1979

APPENDIX A

T. C. Memo. 1978-70

UNITED STATES TAX COURT

Docket Nos. 8921-75
8922-75

Filed February 23, 1978

RICHARD R. QUINLIVAN and ANN M. QUINLIVAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ROGER P. QUINLIVAN and JOYCE E. QUINLIVAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Clinton A. Schroeder and *Frederick J. Gerhart*, for the petitioners.

Dale L. Newland, for the respondent.

MEMORANDUM OPINION

FAY, *Judge*: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Dkt. No.	Petitioner	Year	Deficiency
8921-75	Richard R.	1967	$5,919.89
	and Ann M.	1968	7,011.31
	Quinlivan	1969	3,640.70
8922-75	Roger P. and	1967	3,809.91
	Joyce E.	1968	4,987.97
	Quinlivan	1969	3,530.34

These cases were consolidated for purposes of trial, briefing, and opinion. Richard R. Quinlivan and Roger P. Quinlivan will be hereinafter referred to individually as Richard or Roger and referred to collectively as the petitioners.

Petitioners are lawyers and were members of the same law firm during all relevant times herein. Until its incorporation as a professional association in 1969, the law firm operated as a partnership.

Due to concessions, the remaining issue for decision is whether in computing petitioners' share of income from their law practice, a rental expense deduction under section 162(a)(3),[1] should be allowed for payments made for the use of property which petitioners had previously transferred to two short-term trusts.

All of the facts in this case have been stipulated and are so found.

At the time their petitions in this case were filed, petitioners and their wives resided in St. Cloud, Minn. Each petitioner and his spouse filed a joint Federal income tax return for 1967, 1968, and 1969 with the Internal Revenue Service Center in Kansas City, Mo.

In 1962 petitioners were engaged in the active practice of law. In that year, they began construction of a building designed for general purpose office space. Richard and Roger each owned an undivided one-half interest in the building which, upon its completion, contained some 3,275 square feet of office space. In April 1963 the law firm of which petitioners are members became the sole occupant of the building.

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.

On January 2, 1964, Richard and Roger each executed, as grantors, a 10-year 6-month irrevocable Trust Agreement creating two trusts for the benefit of their respective children. Richard and Roger each retained a reversionary interest in their respective trusts.

On that same day, Richard and Roger, as grantors, together with their wives, conveyed the realty to the Northwestern National Bank of Minneapolis, trustee.[2] After the creation of the trusts, the law firm, as lessee, and the trustee, as lessor, entered into a lease of the realty held by the trusts. The initial lease was for a three-year term and was dated January 2, 1964. At the end of the three-year term, the lessee had the option of renewing the lease "at a rental and terms to be agreed upon." [3]

Throughout the existence of the trusts, the law firm remained as the sole tenant of the building. During the years in issue, the rent paid by the law firm was reasonable in amount and represented the fair rental value of the office space. After the termination of the trusts on July 2, 1974, the law firm leased the office space from petitioners for an amount

[2] Petitioners were not in any way connected with the trustee bank as a shareholder, officer, depositor, or employee during any of the years involved.

[3] Subsequent to the initial term, the law firm and the trustee periodically negotiated new written leases of the office space. For each of the years in issue, a one-year written lease was agreed upon.

which was not less than the highest rent paid to the trustee during the period it held the property.

The following is a summary of the rent paid by the law firm during the years in issue:

Taxable Year Ended	Monthly Payment	Yearly Total
December 31, 1967	$ 925	$11,000
December 31, 1968	950	11,400
October 31, 1969 [4]	1,000	10,000

Upon receipt of the monthly payments, the trustee allocated one-half the rental income to each trust.[5]

The issue presented is whether the rental payments made pursuant to the lease during the years in issue may be deducted as an ordinary and necessary business expense under section 162(a)(3).[6]

[4] After its incorporation in 1969, the law firm elected to be governed by the provisions of subchapter S of the Code. It also adopted a fiscal year ending October 31.

[5] None of the rent paid by the law firm to the trustee was ever expended either for the benefit of Richard or Roger or for the support of any of the beneficiaries of the two trusts. All of such rent was invested for the sole benefit of the beneficiaries.

[6] Sec. 162(a)(3) provides:

> (a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> > (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

In *Mathews* v. *Commissioner*, 61 T.C. 12 (1973), revd. 520 F.2d 323 (5th Cir. 1975), cert. denied 424 U.S. 967 (1976), we set forth our view as to the appropriate test for deductibility of rental payments by the grantor in a gift and leaseback arrangement. In so doing, we held that such payments are deductible if the following requirements are met: (1) "The grantor must not retain 'substantially the same control over the property that he had before' he made the gift." (2) "The leaseback should normally be in writing and must require payment of a reasonable rental." (3) "The leaseback (as distinguished from the gift) must have a bona fide business purpose." (4) In addition, the taxpayer must not possess a disqualifying "equity" in the property within the meaning of the statute.[7]

Based on a careful examination of the facts as presented, we find these requirements have been met.

First, a fundamental prerequisite to the deductibility of rental payments in a gift and leaseback arrangement is the relinquishment by the grantor of a quantum of control over the property which is not

[7] Respondent urges, in essence, that we abandon the requirements set forth in *Mathews* v. *Commissioner*, 61 T.C. 12 (1973), revd. 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976), in favor of an overall business purpose test. Specifically, respondent argues that there must be a business purpose for the gift as well as the leaseback. We have previously considered and rejected this contention, and see no compelling reason to alter our position at this time. See *Serbousek* v. *Commissioner*, T.C. Memo. 1977-105, appeal to the Eighth Circuit dismissed per stipulation of the parties (Jan. 12, 1978).

insignificant in comparison to the control that he enjoyed prior to making the gift. In this regard, we stated in *Mathews* that this requirement "is usually met through a transfer to an independent trustee who has the right and the opportunity to negotiate regarding the leaseback and who acts for the primary benefit of the beneficiaries, rather than the grantor."

In the instant case, it is undisputed that the trusts were valid and irrevocable under Minnesota law. The trustee was a corporate entity in which the petitioners were not in any way connected as a shareholder, director, officer, depositor, or employee. Nor was the leaseback prearranged. Coupling these factors with the fiduciary obligations imposed upon local law, we conclude that the trustee acted independently of the petitioners-grantors. Moreover, under the terms of the trusts, the trustee had broad powers and, of particular import, it had the unfettered power to "sell, lease, exchange or otherwise dispose of the property" held in the trusts, including the building. We believe the evidence sufficient to infer that the trustee carried out its fiduciary duties in accordance with these broad powers granted to it under the trust agreements. Nor does respondent seriously dispute this. Furthermore, as in *Mathews*, the trustee periodically renegotiated the lease of the property which was renewable only under mutually agreeable terms. Specifically, for each of the years in issue, the trustee negotiated a one-year written lease of the office building in what we, based on the evidence, believe were arm's-length transactions. In

addition to negotiating renewals, the trustee collected the rents due under the lease and applied the net income of the trusts for the benefit of the income beneficiaries. In light of these facts, we cannot say that the trustee's functions and independence were illusory. See *Penn* v. *Commissioner*, 51 T.C. 144 (1968); *Van Zandt* v. *Commissioner*, 40 T.C. 824 (1963), affd. 341 F.2d 440 (5th Cir. 1965), cert. denied 382 U.S. 814 (1965). Thus, we hold that petitioners relinquished sufficient control over the realty to satisfy the first requirement in *Mathews*.

As to the second requirement, the lease in question was in writing, and the parties have agreed that the rent thereunder was reasonable for the property.

Petitioners likewise satisfy the third requirement: a business purpose for the lease. Petitioners' continued use of the realty was essential to their law practice. After the petitioners conveyed the realty to the trustee, their continued possession of the premises was wholly conditioned upon the payment of rent. Under such circumstances, the execution of the lease was a matter of business necessity. *Oakes* v. *Commissioner*, 44 T.C. 524 (1965); compare *Wiles* v. *Commissioner*, 59 T.C. 289 (1972), affd. 491 F.2d 1406 (5th Cir. 1974).

With respect to the fourth requirement in *Mathews* we cannot agree with respondent's contention that petitioners possessed an equitable interest or "equity" in the realty within the meaning of section 162(a)(3). Briefly stated, petitioners' reversionary interest was not derived from the lease or the lessor and

would only become possessory after the termination of the trusts. Therefore, such interest is not within the prohibition of section 162(a)(3). *Mathews* v. *Commissioner, supra,* at 23.

Accordingly, on the basis of the particular facts and circumstances involved herein, we hold the rental payments in question are deductible as ordinary and necessary business expenses.

Decisions will be entered under Rule 155.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 78-1653

RICHARD R. QUINLIVAN and ANN M. QUINLIVAN,
ROGER P. QUINLIVAN and JOYCE E. QUINLIVAN,
APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

Appeal from the United States Tax Court

Submitted: February 14, 1979

Filed: May 24, 1979

Before GIBSON, Chief Judge, HENLEY, Circuit Judge, and HANSON, Senior District Judge.*

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* The Honorable William C. Hanson, Senior United States District Judge, Southern District of Iowa, sitting by designation.

GIBSON, Chief Judge.

The Government appeals from a decision of the Tax Court[1] holding that Richard and Roger Quinlivan[2] are entitled to deduct rental payments made to a short-term, so-called Clifford trust set up in accordance with sections 671 through 678 of the Internal Revenue Code of 1954, 26 U.S.C. §§ 671-678. The payments were made for the use of an office building previously owned by the taxpayers and transferred by them to a trustee for the benefit of the taxpayers' children. After carefully considering the arguments of the parties and the pertinent statutory and case authority, we affirm.

Richard and Roger Quinlivan are attorneys who reside in St. Cloud, Minnesota. They began the practice of law with their father in the 1950s and continued as members of the same firm following his death in 1961. In 1963, the firm moved into an office building owned by the two brothers as tenants in common. Then on January 2, 1964, each taxpayer transferred his one-half interest in the property to Northwestern National Bank of Minneapolis as trustee under separate trusts for the benefit of the children of each taxpayer.

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[1] The Honorable William M. Fay, United States Tax Court.

[2] Ann M. Quinlivan and Joyce E. Quinlivan are the wives of Richard and Roger, respectively. They are involved in this action by virtue of their having filed joint income tax returns with their husbands. References to "taxpayers" in this opinion mean Richard and Roger, whose legal business generated the challenged deductions.

The trust documents were executed January 2, 1964, and were irrevocable for a period of ten years and six months; at the end of that time trust property reverted to the grantor-taxpayers. Neither the taxpayers nor their wives were connected with the trustee during the years here involved as a shareholder, director, officer, depositor, or employee. All parties agree that under sections 671 through 678 of the Internal Revenue Code of 1954, the income of the trusts was properly taxed to the beneficiaries. Nor is there any question that the taxpayers treated the establishment of the trust properly under the gift tax laws and the laws of Minnesota.

Shortly after January 2, 1964, the trustee and the taxpayers' law firm entered into a written lease of the premises to the law firm. The initial lease was for three years and contained a renewal option "at a rental and terms to be agreed upon." Subsequent agreements increased the rent and continued the law firm's tenancy; each agreement contained the same renewal option. It is stipulated that reasonable rental payments were made to the trustee. During the 1967, 1968, and 1969 taxable years involved in this case, the law firm was composed of Richard and Roger Quinlivan and Gerald Williams.[3] The law firm deducted from its income the rental payments made to the trustee.

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[3] During 1967 and 1968 the law firm was a partnership. In 1969, it was converted to a corporation and chose a taxable year ending October 31, 1969.

In 1975, the Commissioner issued notices of deficiency to the taxpayers and their wives. This was based in part on computation of an increased distributive share of law firm income for each taxpayer after the Commissioner disallowed the rental deductions. Petitions contesting the deficiency notices were filed in the Tax Court. After other issues were settled, the rent deduction issue was submitted to the court on an agreed statement of facts. The Tax Court held the rent deductions were allowable. The Commissioner appeals, positing the issue of "whether the rentals paid are a necessary and ordinary business expense notwithstanding the fact that the obligation to pay such rentals arose out of a transaction serving no business purpose and having tax avoidance as its sole objective."

I

In analyzing the correctness of the conclusions of the Tax Court, we first look at the statutory basis for this deduction. Section 162 of the Internal Revenue Code of 1954 provides, in pertinent part:

> (a) In general.—There shall be allowed all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> * * * *
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

In applying tax statutes, including the Internal Revenue Code, the literal meaning of the words chosen by Congress is most important. *Masonite Corp.* v. *Fly*, 194 F.2d 257, 260-61 (5th Cir. 1952). Mr. Justice Douglas noted and elaborated on this concept when he wrote:

> Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.

Lewyt Corp. v. *Commissioner*, 349 U.S. 237, 240 (1955).

Examining section 162(a)(3) from this perspective, we find that Congress has expressly provided for the deduction of rental expenses where:

> (1) the payments are required to be made for the continued use or possession of the property;
>
> (2) the continued use or possession of the property is for purposes of the trade or business;
>
> (3) the taxpayer has not taken and is not taking title to the property; and
>
> (4) the taxpayer has no equity in the property.

If all four requirements are met, the law firm is entitled to the deduction and the Tax Court's decision must be affirmed.

It is clear that the first requirement has been established. The law firm was required to pay rent under the written leases for the years in question. Had the payments not been made, it is undisputed that the bank as trustee would have been under a fiduciary obligation to evict the law firm and rent the property to others or to sue the law firm for the rent. The trusts were valid and enforceable under Minnesota law. There is no reason to believe that the independent trustee in this case would have violated its fiduciary duties and permitted the law firm to remain in the building without paying rent.

Similarly, it is clear that the continued use of the property was for the purposes of the law firm's business. It could not function without the office space it rented. In like manner, the third requirement is met by title being in the trustee; certainly the law firm was not purchasing the office building.

The fourth requirement in section 162(a)(3) is that the taxpayer have no equity in the property. On appeal, the Government has not argued that the taxpayers have a disqualifying equity here. The Tax Court noted the taxpayers' "reversionary interest was not derived from the lease or the lessor and would only become possessory after the termination of the trusts. Therefore, such interest is not within the prohibition of section 162(a)(3)." Memorandum opinion at 9. We agree. The prohibition on equitable

interests seems designed to fill the gaps around the third requirement dealing with title to the property. Taken together, they were intended to prevent the taxpayer from receiving or improperly benefiting from the deducted rental payments.

It is clear that application of the plain meaning of section 162(a)(3) to the facts of this case justifies the deduction. This is a sufficient basis for affirmance of the Tax Court.

II

Despite the clear application of the statute, the Government has contended for many years that rental deductions should not be allowed where the leased property was previously owned by the lessee and given by him to the lessor. The Government urges that a deduction is allowable only if there was a "business purpose" for the "entire transaction," including the transfer of the property from the taxpayer and the leaseback. Years of litigation has resulted in a few cases adopting the Government's rationale. *See, e.g., Mathews* v. *Commissioner*, 520 F.2d 323 (5th Cir. 1974), *cert. denied*, 424 U.S. 967 (1976); *Perry* v. *United States*, 520 F.2d 235 (4th Cir. 1975), *cert. denied*, 423 U.S. 1052 (1976); *Van Zandt* v. *Commissioner*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965). On the other hand, in addition to all recent cases of the Tax Court not appealable to the Fifth Circuit, several courts have adopted positions inconsistent with the Commissioner's contentions and consistent with our holding in this case. *Brooke* v. *United States*, 468 F.2d 1155 (9th Cir. 1972); *Brown* v. *Commissioner*, 180 F.2d

926 (3d Cir.), *cert. denied,* 340 U.S. 814 (1950); *Skemp* v. *Commissioner,* 168 F.2d 598 (7th Cir. 1948); *Engel* v. *United States,* 400 F. Supp. 5 (W.D. Pa. 1975), *aff'd by evenly divided en banc court,* No. 76-1889 (3d Cir. Aug. 3, 1977).

Following the decisions in *Brown* and *Skemp,* the Tax Court has taken the lead in developing a consistent body of law in this area. In the present case the Tax Court stated four requirements which it had previously applied in *Mathews* v. *Commissioner,* 61 T.C. 12 (1973), *rev'd,* 520 F.2d 323 (5th Cir. 1975), *cert. denied,* 424 U.S. 967 (1976). The four requirements were:

> (1) "The grantor must not retain 'substantially the same control over the property that he had before' he made the gift." (2) "The leaseback should normally be in writing and must require payment of a reasonable rental." (3) "The leaseback (as distinguished from the gift) must have a bona fide business purpose." (4) In addition, the taxpayer must not possess a disqualifying "equity" in the property within the meaning of the statute.

Memorandum opinion at 6.

These tests complement the statutory standards discussed above. They provide a specific approach for application of the statute in gift-leaseback situations. We are satisfied that any expenditure which fails these requirements would also fail the statutory standards.

We recognize that for tax purposes the overall nature of a transaction must be considered. Certainly in these situations of gifts and leasebacks, the gift aspect is a relevant factor to consider in several respects. If no independent trustee is present, then the existence of a gift brings into question whether there was in fact any "requirement" that rent be paid and also suggests the possible existence of a disqualifying equity. However, the Congress has specified that the business purpose test is concerned with the "continued use or possession" of the property. There is no justification for adding an inquiry into the origin of the lessor's title in applying this requirement.

In short, to the extent that there may be a split in the courts on this issue,[4] we adopt the majority

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[4] It is not clear that there exists a true split among the courts of appeals. The Government primarily relies on *Mathews, Perry,* and *Van Zandt* involved a situation in which the settlor-taxpayer was also the trustee. Similarly, in *Perry,* the Fourth Circuit found that the trustee's independence was illusory due to tightly drawn leases; this result may have been consistent with the majority view. *Mathews* did take a position more hostile to taxpayers in a similar situation. *Van Zandt* and *Mathews* were decided by the Fifth Circuit as was *Audano* v. *United States,* 428 F.2d 251, (5th Cir. 1970). *Audano* held for the Government in a similar situation but carefully considered traditional tests, including the reasonableness of the rental payments. 428 F.2d at 256-57. *Audano* was decided after *Van Zandt* but before *Mathews,* and has not been overruled. Thus the real conflict may be among cases in the Fifth Circuit.

view as applied by the Tax Court below. This is a second basis for affirmance.

III

Even if we were not convinced that section 162 (a)(3) expressly authorizes the taxpayers' position and that the majority view adopted by other courts is correct, we would still affirm the Tax Court. There is an interplay between section 162 and sections 671-678 of the Internal Revenue Code of 1954. The latter sections provide detailed rules governing the taxation of income to the beneficiary of donative trusts; typically this means less tax is paid than would be otherwise. If these rules are carefully followed, the grantor of a trust will not be taxed on the income generated by the gift; instead the beneficiaries will bear that burden.

As we noted above, the trusts in this case were valid and resulted in the income of the trusts being taxed to the beneficiaries. The interplay with section 162 occurs because a deduction for rental payments is essential if the grantor-taxpayers are to gain any tax benefit from the arrangement. It is the Government's essential position that the law firm's payments to the trust amounted to gifts *but* that it was taxable income to the beneficiaries.

Following the Government's approach, sections 671-678 would produce a benefit only in cases where investment property—not used in the grantor's trade or business—is placed in trust. Persons whose assets consist largely of business property would be

excluded from a tax benefit clearly provided by Congress.[5]

The Government defends this result by relying on a single sentence contained in a Senate committee report dealing with the 1954 Code. Referring to sections 671-678, the report stated: "This subpart also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement." S. Rep. No. 1623, 83rd Cong., 2d Sess., pp. 364-72, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 5006. Obviously, this statement, contained in a lengthy committee report and not paralleled in the House report, aids the Government's case but is of questionable weight.

If we accept this strand of legislative history as conclusive, we implicitly assume that in enacting the 1954 Code, Congress considered the propriety of deductions similar to those involved in this case. Making that assumption, we are immediately faced with the fact that the two leading cases deciding this issue before 1954 were *Brown* v. *Commissioner*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950), and *Skemp* v. *Commissioner*, 168 F.2d 598 (7th Cir. 1948). Both of those cases favored the taxpayers.

[5] Presumably, the Government's position would permit an office building to be placed in trust under these sections so long as the grantor didn't occupy any of the premises. Thus an elaborate plan of a gift of vacated office space followed by rent of other office space would satisfy the Government, although the substance of the transaction would be identical with that involved here.

Since Congress was rewriting the entire Code and made no pertinent change in the section dealing with business deductions, we can only conclude that it approved the result in *Brown* and *Skemp*.

We are left with a firm conviction that if section 162(a)(3) and sections 671-678 are considered *in pari materia*, the taxpayers are entitled to the rent reduction. On the other hand, if the sections are not considered together due to legislative history, we can only conclude that Congress wished to continue the law existing in 1954. In either event, the judgment of the Tax Court must be affirmed.

As noted by the Supreme Court: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted * * *." *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935). *See also Knetsch* v. *United States*, 364 U.S. 361 (1960). The law permits the method of tax minimization chosen by the Quinlivans.

Judgment affirmed.

A true copy.

Attest:

Clerk, U.S. Court of Appeals, Eighth Circuit.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 78-1653

September Term, 1978

[Filed May 24, 1979]

RICHARD R. QUINLIVAN; ANN M. QUINLIVAN, ROGER P. QUINLIVAN; JOYCE E. QUINLIVAN, APPELLEES

vs.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

Appeal from the United States Tax Court

JUDGMENT

This Cause came on to be heard on the record of the United States Tax Court, appendix and briefs of the respective parties and was argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the Tax Court be and is hereby affirmed in accordance with opinion of this Court.

Costs taxed in favor of Appellees:	May 24, 1979
Costs of printing 10 copies of brief:	$64.00
Total costs of Appellees for recovery from Appellant:	$64.00

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * *

SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS.

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of

the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

SEC. 672. DEFINITIONS AND RULES.

(a) Adverse Party.—For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) Nonadverse Party.—For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

(c) Related or Subordinate Party.—For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is—

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate em-

ployee of a corporation in which the grantor is an executive.

For purposes of section 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) Rule Where Power Is Subject To Condition Precedent.—A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

SEC. 673. REVERSIONARY INTERESTS.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

(b) [Repealed].

(c) Reversionary Interest Taking Effect at Death of Income Beneficiary.—The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the

person or persons to whom the income therefrom is payable.

(d) Postponement of Date Specified for Reacquisition.—Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

SEC. 674. POWER TO CONTROL BENEFICIAL ENJOYMENT.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(b) Exceptions for Certain Powers.—Subsection (a) shall not apply to the following powers regardless of by whom held.

(1) Power to apply income to support a dependent.—A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after expiration of 10-year period.—

A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(3) Power exercisable only by will.—A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of a grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) Power to allocate among charitable beneficiaries.—A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions).

(5) Power to distribute corpus.—A power to distribute corpus either—

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withhold income temporarily.—A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such ac-

cumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary.—A power exercisable only during—

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this para-

graph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income.—A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) Exception for Certain Powers of Independent Trustees.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(d) Power to Allocate Income if Limited by a Standard.—Subsection (a) shall not apply to a

power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

SEC. 675. ADMINISTRATIVE POWERS.

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) Power to deal for less than adequate and full consideration.—A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than as adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security.—A power exercisable by the grantor or a nonadverse party, or both, enables

the grantor to borrow the corpus or income directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds.—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

(4) General powers of administration.—A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investment or reinvestment, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

SEC. 676. POWER TO REVOKE.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) Power Affecting Beneficial Enjoyment Only After Expiration of 10-Year Period.—Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(b) Obligations of Support.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or cotrustee, may be applied or distributed for the support or maintenance of a beneficiary (other than grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount

paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

(a) General Rule.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception Where Grantor Is Taxable.—Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) Obligations of Support.—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support of maintenance of a person whom the holder of the power is obligated to support or

maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(d) Effect of Renunciation or Disclaimer.—Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

* * * *

Treasury Regulations on Income Tax (1954 Code), Section 1.671-.1.

Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.

* * * *

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October Term, 1979

No. 79-643

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

RICHARD R. QUINLIVAN and ANN. M. QUINLIVAN, et al.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court, supporting the position urged by the respondents herein, was filed on February 23, 1978. This opinion was not officially reported.[1] The opinion of the Eighth Circuit Court of Appeals, affirm-

[1]The opinion of the Tax Court is reproduced in Appendix A to the Petition, referred to herein as "Pet. App. A."

ing the decision of the Tax Court is reported at 599 F.2d 269.[2]

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition.

QUESTION PRESENTED

Whether respondents are entitled to a deduction for their proportionate share of rental payments for office space made by a law firm of which they were members to an independent trustee of short-term trusts established by respondents for the benefit of their children, to which trusts respondents previously had transferred improved real property pursuant to Sections 671 through 678 of the Internal Revenue Code of 1954.

STATUTES INVOLVED

Section 162(a)(3) and Sections 671 through 678 of the Internal Revenue Code of 1954 (26 U.S.C.).[3]

STATEMENT

In general, respondents are satisfied with the statement of the facts of the case set forth in the Petition. However, respondents wish to draw the Court's attention to several facts not adequately emphasized in the petitioner's statement, all of which bear on petitioner's assertion that the gift and leaseback transaction involved herein were "prearranged."

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[2]The opinion of the court of appeals is reproduced in Appendix B to the Petition, referred to herein as "Pet. App. B."

[3]These statutes are reproduced in Appendix D to the Petition.

1. On January 2, 1964 respondents established short-term trusts for the benefit of their children under Sections 671 through 678 of the Internal Revenue Code of 1954, and that same day transferred property to the trusts. (Pet. App. A at 3a). These trusts were irrevocable for a term of ten years and six months. (Pet. App. A at 3a). The initial lease of the trust property was executed three weeks later, on January 21, 1964, for a term of three years. (Pet. App. A at 3a; Ex. 12-L). During the taxable years 1967, 1968 and 1969 at issue herein the lease of the trust property was renegotiated annually, in what the Tax Court concluded were "arm's-length" transactions. (Pet. App. A at 6a).

2. The lessees of the trust property during the taxable years 1967, 1968 and 1969 in issue were not the respondents, but a law firm composed of respondents and an independent third attorney, Gerald Williams. (Pet. App. B at 11a and note 3; Ex. 7-G). Although petitioner has drawn the inference that at the time the initial lease was executed in 1964 respondents were the only members of the law firm, this is merely an inference, and is not supportable by the record. Indeed, a more reasonable inference is that the failure of petitioner to introduce into evidence the law firm's tax return for 1964, which it easily could have done and which would show how many members the firm had in 1964, indicates that there were in fact members in addition to respondents at that time.

3. Under the terms of the trusts, the trustee had broad powers, including, in the words of the Tax Court, "the unfettered power to 'sell, lease, exchange or otherwise dis-

pose of the property' held in the trusts. . . ." (Pet. App. A at 6a).

REASONS FOR DENYING THE PETITION

The petition for a writ of certiorari should be denied for the following reasons:

1. THE COURT BELOW FULLY CONSIDERED THE ISSUES PRESENTED BY THE FACTS OF THIS CASE AND DECIDED THEM CORRECTLY.

The court below fully and correctly considered the issues raised by the facts of this case. Petitioner's criticism of the decision of the court below, which it characterizes as "fundamental error," is predicated, in part, upon its consistent failure throughout the course of this litigation to deal with these facts. Petitioner insists, contrary to the conclusion drawn by the Tax Court after it had heard all of the evidence in this case, that the gift and the leaseback were "prearranged."[4] Thus, petitioner argues, both the gift and the leaseback should be treated as a single, integrated transaction, and a deduction for rental payments made pursuant to the leaseback should be denied unless both the gift and the leaseback were motivated by a substantial business purpose.

Although the gift and leaseback may be "prearranged" in the petitioner's hypothetical "typical" case set out at pages 8 and 9 of the Petition, there is no evidence to support such an assertion here. Unlike the "typical" case, the leaseback in the instant case was not "simultaneous" with the transfer of property to the trusts, but occurred three

[4]The Tax Court concluded: "(n)or was the leaseback prearranged." (Pet. App. A at 6a).

weeks after that transfer.[5] Second, the period of the initial leaseback was not "for a total period . . . co-extensive with the term of the trust," as in the typical case, but for a period of three years, which period expired prior to the years here in question. (Pet. App. A at 3a). During taxable years 1967, 1968 and 1969 in question the lease was subject to annual renegotiation. (Pet. App. A at 3a, note 3). Third, unlike the "typical" case, the *grantors* did not lease the building back from the trusts; rather, a law firm, composed of the grantors and an independent third person, was the lessee.[6] In any case, there is no basis upon which to predicate a different result in this dispute depending upon who were the initial lessees of the trust property.

The petitioner's description of the "typical" transaction does not at all mention the significance of the degree of independence of the trustee from the domination and influence of the grantor, which is an obvious factor bearing on the likelihood of "prearrangement" between those parties. In the instant case the Tax Court found that the grantors were "not in any way connected with the trustee bank as shareholder, officer, depositor, or employee" during any of the years involved. (Pet. App. A, at 6a). Petitioner also neglects to mention that the trustee in the instant case had common law fiduciary obligations to the trust

[5]The trusts were established and the property was transferred to them on January 2, 1964. (Pet. App. A at 3a). The initial lease was executed on January 21, 1964. (Ex. 12-L).

[6]During the 1967, 1968 and 1969 taxable years in issue the law firm was composed of Richard and Roger Quinlivan, the respondents, and Gerald Williams. In 1967 and 1968 the law firm was a partnership. In 1969 it became a corporation. (Pet. App. B at 11a and n.3; Ex. 7-G).

beneficiaries to act reasonably and prudently in renting the trust property.

Petitioner's insistence on treating the gift and leaseback in the instant case as a single, integrated transaction also contravenes a recent decision of this Court regarding the applicability of integrated, or "step," transaction analysis in tax cases. *See Frank Lyon Co. v. United States,* 435 U.S. 561, 575-576 (1978), in which the Court emphasized the significance of the presence of a third, independent party in upholding the characterization of a sale and leaseback as two separate transactions, as opposed to the step transaction approach urged by the Government.

In light of the above, it is clear that the petitioner's assertion of "prearrangement," and its related integrated transaction analysis, are unsupportable as a matter of fact. Thus, the court below acted correctly in applying to the leaseback alone, as opposed to the gift and the leaseback, the tests set forth in Section 162(a)(3) of the Internal Revenue Code of 1954, as construed by the courts, in determining that the deduction for rental payments taken by respondents was allowable.

2. THE RELIEF SOUGHT BY PETITIONER MAY BE PROVIDED ONLY BY CONGRESS.

It is abundantly clear from the Petition that petitioner's concern in this case is not that the standards applied by the court below were incorrect, but that respondents, by virtue of their use of short-term trusts, were able to "shift" taxable income from themselves to their children. However, petitioner never has attacked the validity of the trusts established by respondents. Moreover, the use of short-

term trusts to allocate income from property to one's children or other beneficiaries has long been expressly sanctioned by Congress in Sections 671 through 678 of the Internal Revenue Code of 1954. As the Tax Court recently said, these provisions recognize "that valid trusts can be created which result in splitting family income and minimizing taxes if the grantor does not retain control of the property for his own benefit." *See Lerner v. Commissioner,* 71 T.C. 290, TAX CT. REP. (CCH) ¶35,544 at 3735 (1978).

Petitioner's argument, that both the gift and the leaseback must have a substantial business purpose in order for a taxpayer to obtain a deduction for rental payments on the leaseback, is an attempt to eviscerate the Congressionally sanctioned short-term trust. By its very nature, a gift is not made for a business purpose. The relief petitioner seeks herein amounts to a drastic amendment to the short-term trust provisions of the Internal Revenue Code, which can be effected only by the Congress.

3. THE ALLEGEDLY CONFLICTING DECISIONS RELIED UPON BY PETITIONER ARE DISTINGUISHABLE ON THEIR FACTS.

Petitioner also contends that this Court should grant a writ of certiorari because there is, it alleges, a conflict in the decisions of the federal courts of appeals regarding the circumstances in which rental payments by a grantor-lessee made subsequent to a gift and leaseback are deductible as an ordinary and necessary business expense under Section 162(a)(3) of the Internal Revenue Code of 1954. But, as the court below noted, "(i)t is not clear

that there exists a true split among the courts of appeals." (Pet. App. A at 17a, note 4).

In fact, the allegedly conflicting decisions cited by petitioner can be harmonized. Under Section 162(a)(3) of the Internal Revenue Code of 1954, a deduction for rental payments is allowed only if such payments are "necessary expenses . . . required to be made as a condition to the continued use or possession" of the rented property. In construing this language the courts have recognized that a principal element in determining whether the lessor-lessee relationship between the grantor and the trustee is substantial enough so that the rental payments are indeed necessary expenses required to be made as a condition to the continued use or possession of the property, is the degree of independence of the trustee from the influence and domination of the grantor. Where the trustee was independent from the control of the grantor, as in the instant case, the courts found that the rental relationship had adequate substance to allow the deduction. *See, e.g.: Brooke v. United States,* 468 F.2d 1155, 1157 (9th Cir. 1972) (recognizing that "(m)any decisions pivot on the issue of the independence of the trustee"); *Brown v. Commissioner,* 180 F.2d 926, 929 (3rd Cir. 1950), cert. denied, 340 U.S. 814 (1950) ("(w)hat is controlling is that there came into the picture a new independent owner, the trustee. . . .)" and *Skemp v. Commissioner,* 168 F.2d 598, 599 (7th Cir. 1948) (where the court noted that the taxpayer retained "no significant control over the trust").[7]

On the other hand, where the trustee was not indepen-

[7] *See also: Lerner v. Commissioner,* 71 T.C. 290, Tax Ct. Rep. (CCH) ¶35, 544 (1978), appeal pending, No. 79-4129 (2d Cir.); *Serbousek v. Commissioner,* T.C.M. (P-H) ¶77,105 at p. 77-488 (1977); and *Oakes v. Commissioner,* 44 T.C. 524, 529 (1965).

dent from the grantor the deduction for rental payments has been denied. *See, e.g.,* two of the decisions principally relied on by petitioner in its argument to establish that there is a conflict in the cases: *Perry v. United States,* 520 F.2d 234, 238 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976) (stating that the trustee's independence was "largely illusory"); and *Van Zandt v. Commissioner,* 341 F.2d 440, 443 (5th Cir. 1965), cert. denied, 343 U.S. 928 (1965) ("it seems clear that we do not have the normal relationship that exists when an 'independent' trust is created. . . . Here, with respect to the only asset, the trustee had nothing whatever to do in the management of the trusts. . . .").[8]

The only decision relied on by the petitioner in which the significance of the independence of the trustee was denied is *Mathews v. Commissioner,* 520 F.2d 323, cert. denied, 424 U.S. 967 (1967). However, a factor in the *Mathews* case that significantly disturbed the court, the execution of the leaseback prior to the transfer to the trust, is not a factor in the instant case. Here, as has been noted already, the initial lease of the trust property was not executed until some three weeks after the transfer to the trust.[9]

[8] *See also: Audano v. United States,* 428 F.2d 251, 258 (5th Cir. 1970); *Furman v. Commissioner,* 45 T.C. 360, 364, aff'd, 381 F.2d 22 (5th Cir. 1967) (per curiam); and *Finley v. Commissioner,* 255 F.2d 128, 132 (10th Cir. 1958).

[9] The court below suggested that the real conflict in the cases, if indeed there is any, may be among the cases in the Fifth Circuit. (Pet. App. B at 17a). Even if respondents were to concede that *Van Zandt* and *Mathews,* both Fifth Circuit decisions, conflict with the decisions of the other circuits, it must be noted that in *Audano v. United States,* 428 F.2d 251 (5th Cir. 1970), decided after *Van Zandt* but before *Mathews,* the Fifth Circuit carefully considered the traditional tests used by the other circuits in resolving the issues presented by the case before it.

CONCLUSION

Respondents contend that, to the extent there is confusion in the cases, it is the direct result of the repeated efforts by the petitioner to obtain a judicially imposed amendment to Sections 671 through 678 of the Internal Revenue Code of 1954. Apparently, petitioner's goal is to make the short-term trust provisions of Section 673 unavailable whenever short-term trust property is leased to a party related to the grantor. In its pursuit of this goal and in order to support its step transaction analysis in this case petitioner has asserted, contrary to all of the facts of the case, that the leaseback involved herein was "prearranged."

The facts of this case are clear from the record. The pristine legal issue raised by these facts is whether the short-term trust provisions of the Internal Revenue Code should be unavailable where the grantor and the lessee of the trust property are related parties. The court below found petitioner's arguments to be so unpersuasive that it rejected them on three independent grounds. Yet, petitioner continues to contest this issue in a large number of cases.[10] Were it not for the considerable additional expense and delay that would result from a grant of a writ of certiorari in this case, respondents would not oppose petitioner's request for the writ, so that this Court could take the opportunity to put petitioner's arguments forever to rest. However, in light of the facts of this particular case, and for the reasons above stated, the petition for a writ of certiorari should be denied.

[10]The Petition, at page 12, states that "there are currently 15 docketed cases pending in the Tax Court and 45 additional cases pending at various administrative levels in the Service. . . ."

Respectfully submitted,

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